IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 79-231

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and JOHN E. BRYSON, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK and LEONARD M. GRIMES, JR., the members of said Public Utilities Commission; W. MICHAEL BLUMENTHAL, Secretary of the Treasury, an agency of the United States of America; and JEROME KURTZ, Commissioner, Internal Revenue Service, an agency of the United States of America; CITY OF LOS ANGELES, a municipal corporation; CITY OF SAN DIEGO, a municipal corporation; CITY AND COUNTY OF SAN FRANCISCO, a municipal corporation; TOWARD UTILITY RATE NORMALIZATION, *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

FRANK ROTHMAN
THOMAS H. KUCHEL
2049 Century Park East,
14th Fl.
Los Angeles, CA 90067
(213) 556-8000

ROBERT V. R. DALENBERG
140 New Montgomery St.
San Francisco, CA 94105
(415) 542-1507

Attorneys for Petitioner
The Pacific Telephone and Telegraph Company

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Petitioner, The Pacific Telephone and Telegraph Company, respectfully prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Ninth Circuit entered on July 18, 1979, upholding the judgment of the District Court in which that Court found Petitioner had "met the requirements for the issuance of injunctive relief" but declined to issue a preliminary injunction solely on the ground of res judicata.

OPINIONS BELOW

The order of the District Court, including findings of fact and conclusions of law, is not reported (App. p. 17a). The opinion of the Court of Appeals is not reported (App. p. 1a).

JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

QUESTIONS PRESENTED

1. Does the action of the California Supreme Court in declining to grant certiorari without opinion thereby letting stand the state regulatory commission's construction of the federal Internal Revenue Code which is in direct conflict with a ruling of the Internal Revenue Service, preclude a federal court under the doctrine of res judicata from construing the same provisions of the Internal Revenue Code and granting preliminary injunctive relief where it finds: (1) the Petitioner will suffer irreparable injury if the state's construction of the federal statute is erroneous, and (2) that Petitioner has "met the requirements for the issuance of injunctive relief"?

2. Is the failure of the court of equity to provide a remedy for Petitioner—so that both the State of California and the United States would be bound to a consistent interpretation of the Internal Revenue Code—at odds with the objectives of Congress in establishing the tax incentive program and a violation of the due process clause of the Fifth Amendment to the United States Constitution?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Fifth and Fourteenth Amendments to the United States Constitution; 28 U.S.C. § 1738; pertinent provisions of the Internal Revenue Code of 1954 (26 U.S.C. §§ 46(f), 167(a), 167(*l*)); and Article VI, Section 14 of the California Constitution are reprinted in the Appendix pp. 57a-66a.

STATEMENT

In 1969, 1971, and 1975, Congress established programs to assist regulated utilities through tax benefits created by the deferral and forgiveness of federal taxes through the use of accelerated methods of depreciation and the investment tax credit.[1] For utilities such as Petitioner, Congress provided that eligibility for the tax benefits would be dependent upon the regulatory commission using accounting methods in setting the utility's rates that meet the requirements specified in the Internal Revenue Code and Treasury Regulations. I.R.C. §§ 46(f) and 167(*l*)(3)(G).

Petitioner, in accordance with assurances as to eligibility from the California Public Utilities Commission, has claimed the tax benefits on its federal income tax returns since 1970. By a Decision ("the Decision") in September 1977 the Commission construed the Internal Revenue Code as permitting a change from the accounting procedure theretofore used, which clearly preserved eligibility for the tax benefits, to newly invented

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[1] Tax Reform Act of 1969, Pub.L. No. 91-172, § 441(a), 83 Stat. 625 (1969); Revenue Act of 1971, Pub. L. No. 92-178, § 105(c), 85 Stat. 503 (1971); Tax Reduction Act of 1975, Pub.L. No. 94-12, § 301(a), 89 Stat. 26 (1975).

methods of setting rates designed to flow-through an additional portion of the utility's tax subsidy to the ratepayers by reducing rates. The Commission's action was retroactive to August, 1974 and thus affects eligibility for the tax benefits from that date forward because Petitioner's tax returns are open from 1974 forward. The Commission held that the "maintenance of eligibility under the federal tax laws . . . is an important goal" of the Decision and that its methods of accounting complied with the Internal Revenue Code (App. p. 117a, 119a-120a).

Subsequently the Internal Revenue Service ruled that if effectuated the Decision will destroy Petitioner's eligibility for the tax benefits and has expressed its intent to collect from Petitioner more than one billion dollars ($1,000,000,000) in back taxes and interest which the Commission, as the predicate for its Decision, held were deferred or forgiven.

Under the California procedure, review of Commission action is by writ of certiorari which is discretionary with the California Supreme Court. That Court declined to grant its writ as to the Decision. The California court's action is not reported in the bound reports but was noted in the advance sheets at 21 Cal.3d, Official Advance Sheets, No. 21, minutes p. 3 (1978). The Court's order did not express reasons for its action (App. p. 71a, 72a). Petitioner sought certiorari from this Court and the Solicitor General supported the petition. This Court denied the petition (two Justices voting to grant it) on December 11, 1978, *Pacific Telephone and Tel Co.* v. *PUC,* Docket No. 78-606, —— U.S. ——, 58 L.Ed.2d 713 (1978), and denied rehearing on February 21, 1979.

Petitoner thereafter requested the Commission to examine the I.R.S. rulings, which had been issued subsequent to the Decision, recognize that the Commission's construction of the federal tax law was in error and not implement the Decision until this risk of error could be eliminated by litigation with the I.R.S. This request had two aspects: (1) suspension as to the past period covered by the Decision and (2) suspension of its future application. When the Commission, which had stayed the Decision subject to its further order, on March 14, 1979, directed implementation of the Decision without waiting for litigation with the I.R.S. to settle the tax-eligibility question and without avoiding the continuous accrual of the tax liability, Petitioner brought the action below.

The Complaint is in two alternative counts (App. p. 22a). Count I seeks to restrain implementation of the Decision until after litigation in the normal manner[2] with the I.R.S. to determine the tax eligibility issue. In the alternative, Count II requests a declaratory judgment as to eligibility for the tax benefits. The United States is a party to the second count; the Commission is joined under both counts. The federal statute of limitations will run on the 1974 tax year, which is the first year in issue under the Decision, on September 30, 1979. The I.R.S. has indicated it will protect its position by asserting a tax deficiency before that date.

Petitioner sought a preliminary injunction under Count I. The District Court, after hearing the application for the preliminary injunction, found that Pe-

[2] When the I.R.S. issues a notice of deficiency, the taxpayer may contest the matter in the Tax Court or pay the deficiency and sue to recover the tax in the District Court or Court of Claims.

titioner faced "irreparable injury" if the Decision destroyed the federal tax-eligibility and Petitioner had "met the requirements for the issuance of injunctive relief" (App. p. 20a). But the District Court declined to issue the preliminary injunction on the sole ground that the California Supreme Court's action in refusing (without opinion) to grant certiorari to review the Decision of the Commission was res judicata (App. p. 20a).

The Court of Appeals granted a temporary injunction while it reviewed the District Court's action. On July 18, 1979, the Court of Appeals affirmed the District Court, also solely on the ground of res judicata (App. pp. 4a, 15a).

The federal government has delegated to the state regulator the ability to create or destroy the federal tax subsidy provided by Congress for the private utility. This is because eligibility is dependent upon the manner in which rates are established by the regulator. But the state has not been given the power to determine in a binding fashion whether its action is in accordance with the Internal Revenue Code; that power remains in the federal courts in litigation between the taxpayer and the I.R.S.

The Commission's action was expressly limited to determining the methods that would be used in light of its power, granted by Congress, to control Petitioner's federal tax eligibility. The Commission reviewed the federal law and held

> "Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis." (App. p. 92a)

The only reason Petitioner faces irreparable injury if the Decision is placed in effect is the probability that the state Commission's construction of the federal Internal Revenue Code is erroneous and, if effectuated, will impose on Petitioner [3] a back tax liability in excess of one billion dollars ($1,000,000,000). That liability is growing at a rate of twenty-two million dollars ($22,000,000) per month. (App. pp. 48a, 55a). The effect of the holding below is that the state's interpretation of the federal law, which can only be tested with the I.R.S. in the federal courts, was binding on the federal judiciary in this action.

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[3] Petitioner is forced by the Commission's economic pressure to claim the tax benefits, for the Commission previously held that if Petitioner failed to claim accelerated depreciation, it would nevertheless impute the tax benefits for ratemaking purposes. Re *Pacific Tel. & Tel. Co.*, 69 Cal.P.U.C. 53, 77 P.U.R.3d 1 (1968).

REASONS FOR GRANTING THE WRIT

I

The Judgment Below Is In Conflict With Decisions of This Court and With the Judgments of Other United States Courts of Appeals and With the Rulings of Other Panels of the Ninth Circuit Court of Appeals

The sole question resolved below is that the Decision of the California Public Utilities Commission on the question of Petitioner's federal tax liability must be treated as an estoppel against the consideration of that federal tax question in subsequent litigation in the appropriate federal district court. It must be conceded that the question of estoppel by state court judgment of a question of federal law which is entrusted by Congress to the jurisdiction of the federal courts is in some disarray. But it cannot be gainsaid that the question is a most important one in the administration of the federal courts and demands elucidation by this Court for the guidance of the lower federal courts.

A. This Court's decisions

In *Brown* v. *Felsen,* —— U.S. ——, 60 L.Ed.2d 767 (1979), this Court held that because of the peculiarly federal interest expressed by Congress in bankruptcy matters, the question whether a claim was fraudulent, which had already been the subject of judgment in the state court, should not be treated by the federal court as foreclosed by the state court judgment. Exclusive jurisdiction over such question was vested in the federal courts and they were not to be bound by prior adjudications. The paramount interest and exclusive jurisdiction of the federal courts in the resolution of the tax questions raised below calls for a similar treatment, allowing the tribunal charged by Congress with the resolution of such questions to do so unhampered by the rulings of a state utility commission, particularly when the utility commission's ruling is in direct conflict with a ruling of the Internal Revenue Service on the exact facts in issue before the commission.

In *Will* v. *Calvert Fire Ins. Co.,* 437 U.S. 655 (1978), Mr. Justice Brennan, speaking in dissent on behalf of four members of the Court, indicated that the question of estoppel in such circumstances was "an unresolved and difficult issue," *id.* at 674, but he said, *ibid*:

> "For myself, I confess to serious doubt that it is ever appropriate to accord res judicata effect to a state court determination of a claim over which the federal courts have exclusive jurisdiction; for surely state court determinations should not disable federal courts from ruling *de novo* on purely legal questions surrounding such federal claims."

B. Lower federal court decisions

The proposition announced by Mr. Justice Brennan, in *Will* v. *Calvert, supra,* bears the label "the *Lyons* doctrine" in the lower federal courts after Judge Learned Hand's decision in *Lyons* v. *Westinghouse Electric Co.,* 222 F.2d 184 (2d Cir. 1955), *cert. denied,* 350 U.S. 825 (1955). The decision below is in conflict with this decision of the Second Circuit and also with the pronouncements of other Courts of Appeals as well.

Thus, Judge Wisdom, speaking for the Court of Appeals for the Fifth Circuit, in *American Mannex Corp.* v. *Rozands,* 462 F.2d 688, 690 (5th Cir. 1972), *cert. denied,* 409 U.S. 1040 (1972): ". . . federal tax policy may dictate limited application of collateral

estoppel when there is federal litigation of a state court determination bearing on federal tax liability." The Sixth Circuit, in *Cream Top Creamery* v. *Dean Milk Co.,* 383 F.2d 358 (6th Cir. 1967), denied estoppel to a state court judgment so far as it concerned a claim cognizable exclusively in the federal courts.

Indeed, until the decision below, the *Lyons* doctrine was recognized in the Ninth Circuit itself. See *In re Houtman,* 568 F.2d 651 (9th Cir. 1978); *Red Fox* v. *Red Fox,* 564 F.2d 361 (9th Cir. 1977). The court below did not acknowledge the existence of the decisions of this Court, those of the other circuits, or even those of its own circuit in applying the doctrine of res judicata to the state commission's ruling on the federal tax question in the face of the I.R.S. ruling to the contrary.

It is not, of course, our contention that there has been uniformity among the lower federal courts except for the Ninth Circuit on this question. As the Court of Appeals for the District of Columbia said recently in *New York St. Teamsters, Etc.* v. *Pension Ben.,* 591 F.2d 953, 956-957 (D.C.Cir. 1979):

> "The decision in *Lyons* has received a mixed response from legal commentators, *compare* 1B J. Moore, Federal Practice § 0.445 at 4113-14 (2d ed. 1974) *with* Developments in the Law: Section 1983 and Federalism, 90 Harv. L. Rev. 1133, 1335 n. 20 (1977), and a number of courts have refused to follow it."

The inconsistency of judgments was also noted by Judge Wisdom in *Mannex, supra,* 462 F.2d at 690 n.2.

Res judicata should not have been applied without any analysis of whether doing so would achieve the

goals of the doctrine and whether there are federal interests present that militate against its application. In the instant case the res judicata interests—the provision of a stopping point for litigation, avoidance of double recovery, stability of judgments—cannot be achieved because the key tax-eligibility question must be litigated again with the I.R.S. and the impact of the loss of eligibility will undermine the prior regulatory action. On the other side, the federal interest in uniformity and clarity in federal tax law is very strong. And as Judge Ely pointed out for a different panel of the Ninth Circuit in *Red Fox* v. *Red Fox, supra,* 564 F.2d at 365 n.4, "When there is a strong interest in providing a federal forum, as here, the availability of Supreme Court review as a check on state court determinations of federal rights is inadequate to satisfy such policy. . . . And, of course, the Supreme Court's heavy caseload limits it to a review of a relatively small number of cases. See *England* v. *Louisiana State Board of Medical Examiners,* 375 U.S. 411, 416, 84 S.Ct. 461, 11 L.Ed.2d 440 (1964)."

Surely the time has come for this Court to perform its duty to create a uniform rationalized rule to control the question whether or when a state court adjudication, incidentally resolving a question of federal law contrary to federal interpretation of that law, should estop federal courts from determining issues of law that, by Congressional command, fall within their ambit.

II

Under the California Constitution the Prior Action of the California Court Is Not Entitled to Res Judicata Effect

The court below treated the denial of certiorari by the California court as a determination on the merits even though *no reasons* for the court's action were stated. Ignored was Article VI, Section 14 of the California Constitution, which provides:

> "Decisions of the Supreme Court and courts of appeal that determine causes shall be in writing with reasons stated."

The Court of Appeals relied upon *Napa Valley Electric Co.* v. *Railroad Commission,* 251 U.S. 366 (1920), where this Court held that the denial of a petition for a writ of certiorari by the California Court without opinion in an appeal from a decision of the Commission was on the merits and thus entitled to res judicata effect.

The briefs in *Napa* did not mention the California Constitutional provision and this Court did not consider it in its opinion. In fact the California decisions relied upon by this Court in *Napa* all had met the constitutional requirement of stating reasons for the denial of the writ.[4] The *Napa* decision, rendered before

[4] Cited at 251 U.S. at 372 are: *C. A. Hooper & Co.* v. *Railroad Commission,* 175 Cal. 811 (1917) *memorandum case* (denial of application for writ of review with statement of reason); *E. Clemens Horst Co.* v. *Railroad Commission,* 175 Cal. 660 (1917) (denial of application for certiorari with reasons given); *Mt. Konocti Light & Power Co.* v. *Thelen,* 170 Cal. 468 (1915) (denial of application for writ of certiorari with reasons given); *Ghriest* v. *Railroad Commission,* 170 Cal. 63 (1915) (denial of application for writ of certiorari to review an order of the California Railroad Commission with reasons given).

Erie Railroad Co. v. *Tompkins,* 304 U.S. 64 (1938), was understood to establish the state law and has been followed by the courts without discussion of the Constitutional provision.[5] In this fashion an unfortunate error crept into California jurisprudence: The protection of Article VI, Section 14 was denied appeals from the Public Utilities Commission, but is accorded litigants in all other appeals.[6]

The continuing validity of the *Napa* line of cases is undermined by recognition of the Constitutional protection of Article VI, Section 14 and by the views expressed in *People* v. *Medina,* 6 Cal.3d 484 (1972) where the constitutional requirement was argued. There the court pointed out that to allow conclusive effect to appellate orders that did not state reasons would "evade the state constitutional requirement of written opinions." *People* v. *Medina, supra,* 6 Cal.3d at 490.

The result of adhering to the *Napa* rule is a denial of the equal protection of the state constitutional provision. For the federal court to effectuate such a denial transgresses the protection of the due process clause of the Fifth Amendment.

[5] *Adams* v. *Decoto,* 21 F.2d 221 (S.D. Cal. 1927); *Consolidated Freightways, Inc.* v. *Railroad Commission,* 36 F.Supp. 269, 270-71 (N.D. Cal. 1941); *People* v. *Western Air Lines,* 42 Cal.2d 621 (1954), *appeal dismissed,* 348 U.S. 859 (1954).

[6] *E.g., People* v. *Medina,* 6 Cal.3d 484, 490 (1972); *Funeral Directors Ass'n* v. *Board of Funeral Directors,* 22 Cal.2d 104, 106 (1943); *People* v. *Carrington,* 40 Cal.App.3d 647, 650 (1974); *Traube Pittman Corp., Ltd.* v. *Board of Supervisors,* 49 Cal.App. 2d 463, 464 (1942); *People* v. *Credit Managers Ass'n,* 76 Cal.App. 3d 344, 347 n.3 (1977).

III

The Decision Below Conflicts With Equitable Doctrines Announced by This Court

The court below mistakenly viewed the Commission's decision as a static judgment. The continuing, prospective nature of the Decision is the same as a decree of equity. A court must modify a decree when the law has changed. *System Federation No. 91* v. *Wright,* 364 U.S. 642 (1961). The holding in *System Federation* should have equal application to the continuing regulatory order based upon an erroneous application of federal law. As phrased by this Court:

> ". . . the court cannot be required to disregard significant changes in law or facts if it is 'satisfied that what it has been doing has turned through changing circumstances into an instrument of wrong.' . . . A balance must thus be struck between the policies of res judicata and the right of the court to apply modified measures to changed circumstances." (364 U.S. at 647-648)

The same equitable principles, which are strongly embedded in American law,[7] apply to this action. In finding Petitioner "met the requirements for injunctive relief" the District Court recognized the clear probability[8] that the federal law was contrary to the

[7] *E.g.*, Fed. Rules Civ. Proc., rule 60(b)(5); Calif. Code of Civil Procedure § 473.

[8] This is confirmed by an examination of the Internal Revenue Code and Treasury Regulations and by the I.R.S. rulings which were issued after the Commission entered the Decision. Further confirmation is provided by the amicus brief of the Solicitor General filed with this Court in 78-606 and by the amicus brief of the United States filed June, 1979 with the Court of Appeals. The commentators have also viewed the Commission action as inconsistent with the federal law. Warren, *Tax Accounting In Regulated Industries: Limitations On Rate Base Exclusions,* 31 Rutgers L.Rev. 187; Note, 31 Stanford L.Rev. 265.

Commission's holding and that the Decision had become "an instrument of wrong". At that point the District Court should fashion a preliminary remedy such as that sought here under which effectuation of the Decision is suspended and the rates are collected subject to refund pending final resolution. This is not simply a matter of equity; due process requires relief as does proper recognition of the federal court's role in securing the objectives of Congress in enacting the tax subsidy.

Petitioner is exposed to an ever growing multiple liability. The state Commission requires it to pass a portion of the federal tax subsidy on to the ratepayers by lowering rates. But if too large a portion of the subsidy is so "flowed through"—as the I.R.S. contends—that action itself destroys eligibility and the entire tax benefit must be repaid the federal government. The regulatory Commission professes an inability to correct matters as to the past period once the Decision is placed in effect and refuses to modify its Decision prospectively although it clearly has the power. Calif. Pub.Util.Code § 1708. The closest precedent and one that should be controlling is *Western Union Telegraph Company* v. *Pennsylvania,* 368 U.S. 71 (1961). There the state obtained an escheat order with respect to unclaimed wire transfer funds. This Court held the state court action if permitted to be final denied Western Union due process for it could not bind other claimants, thus exposing the company to multiple liability.

Moreover, it was not the intent of Congress when it enacted the tax benefit program that the intended beneficiary of the program be injured rather than helped. A federal court of equity cannot sit idly by when it concludes an error as to federal law has converted the Congressional program into a vehicle of destruction. Respect for the actual Congressional objectives requires no less.

This suit does not seek an unwarranted federal review of the state administrative process. Both the state policy, as embodied in the Decision, and the federal policy, as enacted in the Code, is to preserve eligibility for the tax benefits.[9] The federal statutes limiting tax litigation with the United States make a resolution more difficult than in the ordinary situation and the complaint seeks a reasonable protective procedure to avoid massive injury. Protecting Petitioner while finally determining the correct construction of the Internal Revenue Code furthers both the state and federal policies.

[9] It would be another matter had California held it did not care about the federal tax benefits and had not sought to preserve them. In such case the matter would be purely one of state regulatory policy, so long as the rates were made with the recognition that the tax subsidy would not then exist.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that certiorari should be granted.

FRANK ROTHMAN
THOMAS H. KUCHEL
2049 Century Park East, 14th Fl.
Los Angeles, CA 90067

ROBERT V. R. DALENBERG
140 New Montgomery St.
San Francisco, CA 94105

Attorneys for
The Pacific Telephone and Telegraph Company

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